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BEFORE THE ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION
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IN THE MATTER OF THE JOINT APPLICATION
OF WILLOW VALLEY WATER CO., INC. AND
EPCOR WATER ARIZONA, INC. FOR APPROVAL
OF THE SALE OF ASSETS AND TRANSFER OF
CERTIFICATE OF CONVENIENCE AND
NECESSITY

DOCKET NO. W-01732A-15-0131

DOCKET NO. W-01303A-15-0131

WILLOW VALLEY WATER CO., INC.'S
CLOSING BRIEF

Arizona Corporation Commission

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TABLE OF CONTENTS

I. EWAZ is well-qualified and the transaction will benefit customers1

II. RUCO’s proposals are untested, dangerous, and bad for ratepayers2

III. EWAZ’s acquisition proposal should be considered as a new and substantial approach to encouraging industry consolidation5

IV. Conclusion7

1 The Commission should approve the Application to transfer the CC&N and utility assets of
2 Willow Valley Water Co., Inc. ("Willow Valley") to EPCOR Water Arizona, Inc. ("EWAZ").
3 There is no question that EWAZ has all the necessary qualifications to obtain the CC&N. Further,
4 the case presents clear customer benefits, including the operational benefit of having "boots on the
5 ground" at EWAZ's larger, nearby system, as well as EWAZ's lower cost of capital (due to its
6 capital structure and lower cost of debt). The Residential Utility Consumer Office's ("RUCO")
7 concern over the loss of Accumulated Deferred Income Tax ("ADIT") is misplaced because the
8 other benefits of this transaction more than outweigh this concern. Moreover, the solutions
9 advocated by RUCO are risky, expensive, and counter-productive to encouraging water utility
10 consolidation. Lastly, EWAZ's acquisition rate proposal merits serious consideration, as a tool to
11 promote consolidation and due to EWAZ's commitment to invest \$1 million in the near term. That
12 investment will address much-needed distribution system improvements—investments Willow
13 Valley is simply not in a position to make in the timeframe EWAZ proposes, given Willow
14 Valley's years of losses and millions of already stranded investment in this system.

15 **I. EWAZ is well-qualified and the transaction will benefit customers.**

16 EWAZ is the largest water company in Arizona, and it is well-qualified to receive the
17 CC&N for this area. No party questions EWAZ's financial, technical and managerial
18 qualifications.¹ And EWAZ has a key advantage—it has a large system with 19,000 customers
19 nearby.² In contrast, Willow's sister companies are over 200 miles away, a very long drive. With
20 a larger pool of employees and equipment close at hand, EWAZ is in a better position to respond
21 to emergencies.³ Likewise, EWAZ is in a better position to cover if an employee is sick or on
22 vacation.⁴ Indeed, EPCOR has 30 employees locally⁵ compared to four employees for Willow

23
24 ¹ Ex. Willow-10 (RUCO Responses to Willow Data Requests) at Responses to Willow 1.2, 1.3 and
25 1.4; Tr. at 516:15 to 521:14 (Michlik); Ex. Willow-12 (Staff Responses to Willow Data Requests)
26 at 1.3, 1.4, 1.5 Tr. at 417:18-23 (Carlson).

26 ² Ex. Willow-1 (Fleming Rebuttal) at 4-5.

27 ³ Tr. at 234-36 (Bradford); Tr. at 127-130 (Fleming).

⁴ Ex. Willow-1 (Fleming Rebuttal) at 4-5.

1 Valley. EWAZ's closer location creates clear operational benefits to Willow Valley's customers.
2 It should also result in lower operational costs.⁶ Simply eliminating the travel costs of sending
3 help from Phoenix or Maricopa is a cost and employee time savings. In addition, Staff's engineer
4 Mr. Liu testified that EWAZ's larger presence in Mohave County "should result in economies of
5 scale savings for Willow Valley in the future."⁷

6 But these are not the only savings. EWAZ has a lower cost of capital than Willow Valley,
7 and this should benefit Willow's customers in the next rate case.⁸

8 Thus, there will be operational and financial benefits for Willow Valley's customers, and
9 there is no question about EWAZ's financial, managerial and technical capability. Despite
10 RUCO's hundreds of pages of testimony, the case for approval is both simple and clear, which is
11 why Staff, Willow Valley and EWAZ all support approving the CC&N transfer and asset transfer.

12 **II. RUCO's proposals are untested, dangerous, and bad for ratepayers.**

13 RUCO's objection concerns the loss of ADIT. ADIT exists due to the difference between
14 the straight line depreciation used for regulatory purposes, and the accelerated depreciation used
15 for income tax purposes.⁹ ADIT is sometimes analogized to a loan from the government;
16 eventually the depreciation difference reverses and the "loan" is repaid.¹⁰ In the meantime,
17 because ADIT is not investor-supplied capital, it is considered a deduction to rate base.¹¹ Here,
18 the "loan" will go away and tax liability will be reflected on the next income tax return of Willow
19 Valley's parent, Global Water Resources, Inc.¹²

21 ⁵ Tr. at 235.

22 ⁶ Ex. Willow-1 (Fleming Rebuttal) at 4-6.

23 ⁷ Ex. S-8 (Liu Direct) at Exhibit JWL, page 1.

24 ⁸ Tr. at 417:23 to 418:16 (Carlson); Tr. 169:16 to 172:10 (Walker); Tr. at 219-224 (Walker); Ex. Willow-7.

25 ⁹ Ex. Willow-6 (Walker Rebuttal) at 3:3-10.

26 ¹⁰ Ex. RUCO-1 (Smith Surrebuttal) at 9.

27 ¹¹ Ex. RUCO-1 (Smith Surrebuttal) at 10:2-7.

¹² Ex. RUCO-1 (Smith Surrebuttal) at 10:9-17.

1 RUCO complains mightily about the loss of ADIT. But the rate value of the ADIT is less
2 than the rate benefit of EWAZ's lower capital costs. Staff calculated the rate value of the ADIT as
3 \$26,000, and the rate benefit EWAZ's lower capital costs as \$29,000.¹³ Using a slightly different
4 calculation, Mr. Walker calculated the rate value of the ADIT as \$27,644 and the rate value of
5 EWAZ's lower cost of debt as \$37,616.¹⁴ Either way, ratepayers do slightly better if the
6 transaction goes through, not even considering the operational benefits and expense savings of
7 EWAZ's large local presence. When these extra benefits are considered, the transaction is a clear
8 win for ratepayers. Therefore, RUCO's primary recommendation to simply reject the transaction
9 is unwarranted.

10 RUCO also suggests imposing a regulatory liability or "hold harmless" provision in the
11 amount of the ADIT. But as Mr. Walker and Mr. Carlson explain, this creates a strong risk of the
12 IRS finding a "normalization" violation, which would prevent EWAZ from using accelerated
13 depreciation in the future, resulting serious harm to ratepayers.¹⁵ Even RUCO's witness, Mr.
14 Smith, concedes that "there could be a normalization concern"¹⁶ and that there "may be a
15 legitimate cause for concern regarding tax normalization requirements."¹⁷ Mr. Smith was aware
16 of only two companies with a "hold harmless" adjustment in his over 30 years of experience, and
17 he refused to publicly name those companies, for fear of exposing them to the IRS.¹⁸ Any tax
18 strategy that must be hidden from the IRS is questionable, at best.

19 Trying to doge this problem, RUCO suggests that the Commission put the transaction on
20 hold and that the Applicants request a "Private Letter Ruling" from the IRS. This solution is not
21 practical. For one thing, the normalization problem is fairly clear—which is why Staff withdrew

22 ¹³ Tr. at 417:23 to 418:16 and 458:18-23 (Carlson).

23 ¹⁴ Tr. at 169:16 to 172:10 and 219-224 (Walker).

24 ¹⁵ Ex. Willow-6 (Walker Rebuttal) at 5-7 and Attachments Walker-1 through Walker-3; Ex. S-6
25 (Carlson Surrebuttal) at 4:1-7.

26 ¹⁶ Ex. RUCO-1 (Smith Surrebuttal) at 23:16-17.

27 ¹⁷ Ex. RUCO-1 (Smith Surrebuttal) at 24:20-21 and Tr. at 46:7-17.

¹⁸ Tr. at 111-113.

1 its regulatory liability recommendation.¹⁹ So there is no reason to think the IRS will respond
2 favorably. Moreover, requesting a PLR will require the assistance of specialized tax accountants
3 and tax attorneys, so it will be expensive. Even the filing fee may exceed the rate value of the
4 ADIT—the likely fee is \$28,300.²⁰ And the delay, while unknown, could be lengthy. Ratepayers
5 deserve the benefits of this transaction sooner, not later. And it is very likely that the expense of
6 seeking a PLR could easily exceed the modest value of the ADIT; or worse, simply cause EWAZ
7 to withdraw from the transaction and the customers will not receive the certain benefits of a less
8 costly capital structure, reduced operational expenses, and EWAZ's commitment to invest \$1
9 million in the system in the near term. In short, RUCO's PLR recommendation is not practical,
10 creates a heightened level of regulatory uncertainty in Arizona, and probably eliminates the
11 benefits to customers of the transaction.

12 RUCO's additional recommendations that the Commission assert control over the attorneys
13 the Applicants can use for the PLR, and to control the content of the PLR²¹, are also impractical
14 and raise serious concerns. Of course, the Commission and RUCO are free to submit their views
15 to the IRS, but to try to control what the Applicants say to the federal government or the attorneys
16 they use to state their case raises serious free speech and due process concerns.

17 Lastly, RUCO suggests that the transaction could be entirely restructured. RUCO's
18 suggestion is not feasible at this late stage – many months of negotiations went into the
19 transaction, requiring the parties to readdress the transaction as a stock sale completely changes
20 the pricing of the transaction. Restructuring the deal would require significant legal expenses,
21 which is a serious concern given the modest appeal of the transaction to both parties. It is not
22 clear if either party would support a restructuring. Moreover, a stock purchase would create
23 liability concerns for the buyer, altering the economic substance of the deal. In addition, Willow

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25 ¹⁹ Tr. at 435: 3-11.

26 ²⁰ See Internal Revenue Bulletin 2015-1 (January 2, 2015) at page 80, Fee Schedule, categories
27 3(c)(ii) and 3(d), available at <https://www.irs.gov/pub/irs-irbs/irb15-01.pdf>. Note that the fees may
be increased each year.

²¹ Tr. at 39-42.

1 Valley has deferred tax assets which would go along in a stock purchase with the ADIT, which
2 would create further complexity in valuing the deal.²² Further, if the deferred tax assets are
3 recognized in rate base, they could offset the ADIT²³, a factor RUCO seems to not have
4 considered.

5 **III. EWAZ's acquisition proposal should be considered as a new and substantial approach**
6 **to encouraging industry consolidation.**

7 EWAZ's proposal can be simply described.²⁴ EWAZ will invest up to a certain amount in
8 needed infrastructure projects for Willow Valley. After a project is completed, in a subsequent
9 rate case EWAZ will receive a slightly higher rate of return on the rate base created by these
10 infrastructure projects. Further, the premium is earned only if water loss is reduced a specified
11 amount. In essence, this is a "return premium" method – an approach used by other states,
12 specifically Pennsylvania²⁵ which has been the nation's leader in water industry consolidation.
13 Ratepayers benefit from needed capital investments that are completed more quickly than
14 otherwise. In addition, the project should help reduce Willow Valley's high water loss.

15 As Mr. Fleming explained, Global Water has invested over \$3 million in Willow Valley,
16 and Willow Valley has operated at a loss each year.²⁶ Under the terms of this transaction, Global
17 will receive about \$2.25 million – meaning Global is selling at a loss.²⁷ Global Water is not in a
18 position to make further capital investments as quickly as EWAZ. And while Global's heavy
19 investment has resolved critical water quality, treatment and safety issues²⁸, much of the
20 distribution system is in very poor shape and needs to be replaced, a very large investment.²⁹

21 ²² Tr. at 176-178 (Walker).

22 ²³ Tr. at 183 (Walker).

23 ²⁴ See Tr. at 369 to 374; Ex. EWAZ-4 (Mahler Rebuttal) at 2 to 10.

24 ²⁵ Ex. RUCO-8 (Michlik Surrebuttal) at Attachment F (RUCO/Responsible Water White Paper) at
Attachment 3 (Pennsylvania Statement of Policy)

25 ²⁶ Ex. Willow-1 (Fleming Rebuttal) at 6.

26 ²⁷ Ex. Willow-1 (Fleming Rebuttal) at 4:13-17.

27 ²⁸ Ex. Willow-1 (Fleming Rebuttal) at 7-13; Tr. at 120-127.

²⁹ Ex. Willow-1 (Fleming Rebuttal) at 14-15.

1 EWAZ's proposal would provide a good start on fixing the distribution system. As Mr.
2 Bradford explained, while EWAZ could replace the entire distribution system at once, the
3 resulting increase in rate base would result in a large rate increase.³⁰ EWAZ's proposal provides a
4 measured approach to addressing the improvements needed.

5 Moreover, approving this proposal would be a good precedent promoting consolidation of
6 troubled utilities—and despite Global Water's millions of investment and years of efforts, Willow
7 remains "troubled": it is experiencing very high water loss due to its deteriorated pipes. Indeed,
8 as Mr. Fleming explained, in some cases the mineral build-up in the pipes was all that was holding
9 the pipes together.³¹ As water quality has improved and the mineral build-up has been flushed
10 from the system, many deteriorated pipes have been exposed.

11 It's no secret that Arizona has too many small water companies, many of them troubled,
12 some much more so than Willow Valley. A rate premium that applies only to new investments
13 made by the new owner is a reasonable step.

14 It's clear that what the Commission has been trying to date has not worked. The number of
15 water companies has only increased in the years since the Water Task Force in late 1990's and
16 early 2000's.³² While the Staff has promoted "acquisition premiums" as a possible approach, they
17 have been very rare.³³ As Staff's witness Mr. Carlson explained, Staff has set a very high bar to
18 approving acquisition adjustments, "generally, Staff has not been conducive to recommending
19 approval of those, because the benefits to the ratepayers did not appear to be apparent. And that's
20 what basically set the standard, was having to quantify the benefits."³⁴

21 In *The March of Folly*, the two-time Pulitzer Prize-winning historian Barbara Tuchman
22 wrote about a "phenomenon noticeable throughout history regardless of place or period is the
23

24 ³⁰ Tr. at 294.

25 ³¹ Tr. at 125-126; 128.

26 ³² Tr. at 213-214.

27 ³³ Tr. at 454:21-25.

³⁴ Tr. at 455:1-6.

1 pursuit by governments of policies contrary to their own interests.”³⁵ She explained that “[The]
2 source of self-deception is a factor that plays a remarkably large role in government. It consists in
3 assessing a situation in terms of preconceived fixed notions while ignoring or rejecting any
4 contrary signs. It is acting according to wish while not allowing oneself to be deflected by the
5 facts. It is epitomized in a historian’s statement about Phillip II of Spain, the surpassing wooden-
6 head of all sovereigns: “No experience of the failure of his policy could shake his belief in its
7 essential excellence.”³⁶

8 In this case, when asked whether this policy has been successful, Staff’s witness, Mr.
9 Carlson candidly addressed whether the Commission’s approach to “encouraging” consolidation
10 has been effective:

11 No, it hasn't been, to be quite honest. Like I say, it's a very rare occurrence. And
12 like I say, the acquisition adjustment and the policy for acquisition adjustment
13 people keep talking about really haven't benefited the small companies where we
14 stand ready to use those for, because it hasn't been enough.³⁷

15 The Commission needs to try a new approach to solving its ongoing history of failure to
16 encourage the consolidation of Arizona’s highly fragmented, and oft-troubled water industry. As
17 Ms. Tuchman explained, “The ultimate outcome of a policy is not what determines its qualification
18 as folly... It qualifies as folly when it is a perverse persistence in a policy demonstrably
19 unworkable or counter-productive.”³⁸

20 **IV. Conclusion.**

21 The Commission should approve the transfer of Willow Valley’s CC&N and utility assets
22 to EWAZ, and it should seriously consider EWAZ’s acquisition proposal.

25 ³⁵ B. Tuchman, *The March of Folly* (Alfred A. Knopf, Inc., New York, 1984 1st ed.), at 4.

26 ³⁶ *Id.*, at 7.

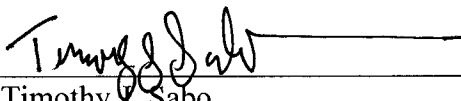
27 ³⁷ Tr. at 455:11-16.

³⁸ B. Tuchman, *The March of Folly*, at 33.

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RESPECTFULLY SUBMITTED this 7th day of December 2015.

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